

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
REPLY BRIEF**

ORIGINAL

77-5036

To be argued by
SOLOMON M. CHESER

United States Court of Appeals

FOR THE SECOND CIRCUIT

IN RE EASTERN FREIGHT WAYS, INC.,

Bankrupt,

SIDNEY B. GLUCK, Trustee in Bankruptcy of EASTERN FREIGHT
WAYS, INC.,

Plaintiff-Appellee,

against

SEABOARD SURETY COMPANY,

Defendant-Appellant,

MANUFACTURERS HANOVER TRUST COMPANY, individually and
as agent for other institutional lenders, INTERNATIONAL HARVES-
TER CREDIT CORPORATION, FRUEHAUF CORPORATION
and THE CHASE MANHATTAN BANK, NATIONAL ASSOCIA-
TION, and THOMAS J. CAHILL, Trustee in Bankruptcy of ASSO-
CIATED TRANSPORT, INC.,

Defendants-Appellees.

On Appeal from the United States District Court for the
Southern District of New York

**REPLY BRIEF OF DEFENDANT-APPELLANT
SEABOARD SURETY COMPANY**

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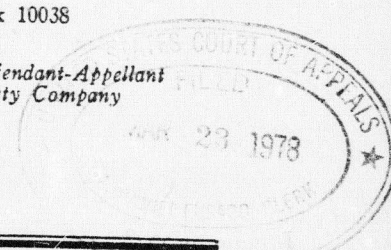


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REPLY BRIEF OF DEFENDANT-APPELLANT SEABOARD SURETY COMPANY

Preliminary Statement

This reply brief is submitted on behalf of the Appel-
lant, Seaboard Surety Company, a defendant below, in
support of its appeal to this Court from the order of
United States District Judge Edmund L. Palmieri, dated
October 31, 1977, and in response to briefs submitted in
opposition by appellees the Eastern trustee, Chase, Manu-
facturers Hanover, International Harvester, and the Asso-
ciated trustee. In this reply brief we do not propose to
react to each and every assertion made in the briefs sub-

mitted by the five appellees. We suggest that many of the assertions and arguments there made have been anticipated and countered in Seaboard's principal brief. We will, however, address ourselves to some areas which we consider important and which, we believe, the appellees have either overlooked or with regard to which they are in error.

POINT I

Appellees have failed to refute Seaboard's contention that, under the *Yale Express* case, Seaboard is entitled to setoffs.

A.

At the outset we suggest that it is significant that in five briefs comprising 141 pages, which cite a plethora of judicial authority, there is a marked absence of cases in which a surety for an insolvent principal was denied the benefit of setoffs.

This is not surprising since the judicial holdings have been consistent with Restatement, Security § 133(2) (c):

“§133. Surety's Set-Off.

* * *

“(2) The surety cannot set off against the creditor the principal's claims against the creditor unless

* * *

“(c) The principal is insolvent.”

Judge Friendly's opinion in *In re Yale Express System, Inc.*, 362 F.2d 111 (2d Cir. 1966), affirmed the soundness of the foregoing principle when he wrote at 114:

“But when the principal is insolvent, the surety may set off the principal's claim, *Clark Car Co. v. Clark*, 48 F.2d 169 (3 Cir. 1931); Restatement, Security § 133 (2) (c), or obtain a decree requiring

the creditor and the principal to adjust their controversies, remaining liable to the creditor only for the amount not covered by the principal's claim against him. [citing cases]"

The rationale for denying the surety of a solvent principal the benefit of setoffs is set forth in *Walcutt v. Clevite Corp.*, 13 N.Y.2d 48, 55-56, 241 N.Y.S.2d 834, 191 N.E.2d 894 (1963), cited and discussed at pages 10 and 11 of our principal brief. *Williston on Contracts*, Third Edition, Vol. 10, § 1251, pp. 799-800 sets forth its view of the rationale thus:

"To an attempt by a surety to set off a cross-claim of the principal which the latter could have set up against the creditor's claim, several objections have been suggested:

"1. That the cross-right is not a mere failure of consideration, but an independent claim, and not being due to the defendant, cannot be claimed by him.

"2. That the principal has a right of election whether his damages shall be claimed by recoupment or counterclaim, or reserved for a cross-action.

"3. That if the surety is allowed to set up the counterclaim it must bar a future action by the principal, and that as the cross-claim might be greater than the creditor's demand, the surety, if allowed to set up the claim merely to defeat the action against him, would also destroy a right of the principal.

"4. That where there are a number of sureties severally liable, if one may set up a counterclaim, another ought to have the same privilege.

"5. That otherwise the creditor may be deprived of his full recovery since, if the surety

successfully offsets the cross-claim of his principal, the latter not being bound by the judgment may subsequently recover on the same claim against the creditor.

"These reasons have generally been thought conclusive; and when the surety is sued alone he has not been allowed to use matter of recoupment, counterclaim, or set-off based on rights of the principal against the creditor unless the surety has taken an assignment of his principal's cross-claim."

Clearly, where the principal is insolvent, the foregoing considerations no longer apply. This was recognized in *Meeker v. Halsey*, 87 F.2d 299 (2d Cir. 1937), a case relied upon by appellees and by Judge Friendly in *Yale Express*. There, after articulating the rule dealing with a solvent principal and giving as reason therefor that "the principal may prefer to reserve his claim against the creditor for prosecution on another occasion," Judge Learned Hand went on to state:

"If however the principal has shown that he means to set off the claim, no injustice is done the creditor if the surety does the same. *Balsley v. Hoffman*, 13 Pa. 603, 611; *Winston v. Metcalf*, 7 Ala. 837; *National Surety Co. v. Breece Lumber Co.*, 60 F.(2d) 847, 851 (C.C.A. 10) (semble). It would seem that this should be a fortiori true when as here the creditor is insolvent, and he and the principal have but one claim against each other." 87 F.2d at 301.

Thus where there is insolvency, we move back to "the underlying theory that a debt should be discharged by the one who in good conscience ought to pay it." 362 F.2d at 116.

We respectfully suggest that "the underlying theory" is indeed "the underlying equity" in this case. To the extent that Eastern's freight charge to a shipper is set off against that shipper's cargo claim, it is Eastern, "the one who in

good conscience ought to pay," that is indeed paying its debt to the shipper. To that extent equitable considerations are best served. And it is on equitable principles that Seaboard relies. Its very right to the benefit of set-offs through subrogation is itself a reflection of equity in action.

On the other hand, the attempt by appellees to invoke equitable principles is rather surprising since they are apparently motivated to support the injunction against informing a shipper of his conceded §68a right to setoff by their fond hope that the shipper might thus be tricked into waiving that right to their own inequitable enhancement.

B.

The holding below and appellees' arguments in chief rest upon the finding that the mere existence of the security afforded by the proceeds of the letter of credit justifies that Seaboard be deprived of or delayed in the exercise of its subrogation right to setoffs. 72 C.J.S. "Principal and Surety" §307b, page 765 states the contrary:

"The rights of a surety to reimbursement from his principal are not affected by his taking security from his principal or from a third person unless there was an agreement that the surety should look to such security only."

The same principle, but going a bit further, is set forth in 50 C.J. "Principal and Surety" §401 (3), pages 248-249:

"The rights of a surety are not affected by taking security from his principal or from a third person, unless there was an agreement that the surety should look to such security only, even though there are other creditors of the principal who are seeking to satisfy their claims out of his property."

We respectfully suggest that Eastern's right to set off its freight charges against a shipper's cargo claim represents "property" out of which the creditor banks "are seeking to satisfy their claims."

The principle thus stated in *Corpus Juris* was applied in *Massachusetts Bonding and Insurance Co. v. Fago Construction Corp.*, 82 F. Supp. 619, 622 (D. Md. 1949):

"The taking of the mortgage and the indemnity agreement by the surety as additional security was not shown to have been under any agreement that the surety would look only to the mortgage and indemnity agreement. In the absence of such an agreement it seems to be well settled that the surety did not lose its equitable lien by subrogation. See 50 C. J. Principal and Surety, p. 248; *Leary v. Murray*, 3 Cir., 178 F. 209, 212, 21 Ann. Cas. 868."

C.

It is argued in our principal brief that the decision in *Yale Express* was grounded on the doctrine of subrogation rather than the "recourse argument" made by the courts below and by the appellees. This Court on page 116 of the *Yale Express* opinion gave its reason why subrogation was applied in that case:

"A prime purpose of the equitable principle of subrogation is to deny a creditor 'the power of throwing the ultimate payment of the debt in one way or another as suits his caprice.' 4 Williston, Contracts § 1265, at 3620 (Rev. ed. 1936). The underlying theory that a debt should be discharged 'by the one who in good conscience ought to pay it,' Restatement, Security § 141, at 384, suggests even more strongly that the principal should not be able to increase the surety's burdens by urging the creditor to proceed against him."

We respectfully suggest that the decision below does indeed give a shipper "the power of throwing the ultimate payment of the debt in one way or another as suits his caprice." A shipper with an available setoff can throw the burden on the surety by paying his debt to the principal in full, or, by applying the setoff, can throw that burden on the principal, "the one who in good conscience ought to pay it."

Moreover, with Seaboard enjoined from informing shippers of their right to setoff, with the trustee completely free to dun these shippers for the full amount of their receivables, there is offended the principle that "the principal should not be able to increase the surety's burdens by urging the creditor to proceed against him." 362 F.2d at 116.

D.

As noted above, the courts below have enjoined Seaboard from informing shippers of their rights to setoff until the proceeds of the letter of credit are exhausted. Such injunction, however, was not conditioned upon a parallel restraint on the trustee, prohibiting his solicitation of payment in full from shippers.

The gross inequity of the foregoing becomes apparent when one considers a factor which, in the main, has been ignored by the appellees.

Because of Eastern's agreement to indemnify Seaboard (R 363a-367a) for Seaboard's liabilities on all bonds and undertakings it executed in the names of Eastern or Associated or any of their subsidiaries, Eastern's ultimate obligation to Seaboard will be not only Seaboard's liability on bonds specifically naming Eastern, but rather on all bonds and undertakings executed in the names of Eastern, Associated and their subsidiaries, less the amount of those Seaboard paid with the proceeds of the letter of credit.

Unquestioned and uncontradicted is the factual statement in the affidavit of the Vice President and Treasurer of Seaboard, Walter S. Wehrell, a man "fully familiar with the relevant facts," that "Seaboard's liabilities on the bonds and undertakings will far exceed the \$2,000,000 we realized from the letter of credit." (R 353a-358a at 358a).

Eastern therefore will remain indebted to Seaboard for Seaboard's liabilities above \$2,000,000 even if, in a proper forum, the entire \$2,000,000 of proceeds of the letter of credit be ultimately determined to be available to Seaboard for the payment of its liabilities on bonds it executed in the names of both Eastern and Associated. To the extent that such Seaboard liability is not reduced because of the failure of shippers to avail themselves of cargo claim setoffs against the Eastern and Associated freight bills, these bankrupt estates will have been inequitably enhanced at Seaboard's expense.

Particularly is this so if the contention of the trustee and the appellees, that setoffs not taken by shippers are waived (R 262a, 320a), should be sustained.

E.

At the October 14, 1976, hearing in the bankruptcy court (R 91a-140a), Seaboard's counsel specifically stated in the presence of the attorney for the appellee, Manufacturers Hanover Trust Company:

"There was no notice to any creditors of the lien. The accounts receivable were assigned, the creditors were not notified of it." (R 104a).

Further statements to the same effect were made in briefs and in argument, always with Manufacturers' counsel present. Never did Manufacturers Hanover avail itself of the opportunities to assert that such statements were being questioned or assert that actual notice of the assignments had been given to shippers. The record on appeal is devoid of any such denial or contention.

Accordingly, it ill becomes counsel for Manufacturers Hanover belatedly to attempt to raise an issue with regard to the giving of actual notice in a footnote at page 29 of their brief where it is asserted by counsel that at trial the giving of actual notice will be proven.

Indeed, nowhere in the complaint (R 257a-268a) is there any allegation that shippers had been given actual notice of the assignments of the accounts receivable. In this connection it is to be noted that the trustee in drafting the complaint carefully included the contentions of the various lenders.

Moreover, Manufacturers Hanover in its cross-claims against Seaboard made no claim that any of the shippers had been given actual notification of the assignment of accounts receivable to it. It is merely alleged at paragraph 35 of its answer (R 312a) that it had "duly perfected its security interest in and to such accounts in the manner prescribed by law. . . ."

Significantly, no other assignee of accounts receivable alleged the giving of actual notice in its cross-claims.

Accordingly, no factual issue involving notice has been raised.

F.

At pages 12-13 of its brief, the appellee International Harvester Credit Corporation states:

"Section 57(i) is the statutory statement of the 'general rule' of subrogation for which *Yale Express* is the exception. Seaboard's lengthy discussion of Section 57(i) to instruct the Court on rights of subrogation fails to take into account that Seaboard is a surety desiring a Section 57(i) subrogation *without* discharging its undertaking to the creditors when it has the means to do so."

It was to meet just such a contention that Judge Friendly in *Yale Express*, 362 F.2d at 115, included the excerpt from *United States ex rel. Johnson v. Morley Coast. Co.*, 98 F.2d 781, 790, which stressed that if the creditor were paid, the setoff would be lost. Judge Hand so stated:

"However, it is only after the surety pays the creditor that he is subrogated to all the creditor's securities, and that would be a condition here, except that the surety cannot pay the debt without losing the security, for it consists only of the creditor's power to defeat the counterclaim by using his claim to cancel it. Therefore to exact of the surety the normal condition of paying the debt, would be to destroy the security, and it follows that he must be allowed to set it up himself."

That Judge Friendly quoted from *Morley* to justify allowing the setoff even though the creditor's claim is not first discharged is evidenced by footnote 3 at 362 F.2d 115:

"One might add that the purpose of the rule conditioning subrogation on full payment by the surety is to protect the creditor against a competing claim by the surety against the principal; there is no occasion to insist on this when a setoff available to the creditor will insure full payment."

G.

In the course of its marshaling of assets argument, Manufacturers Hanover states:

"Since the best estimate presently available is that cargo claims against Eastern aggregate at most approximately \$740,000, there can be little doubt that Seaboard's exoneration claims arising from its payments under the Eastern bonds will be fully paid." (Brief at 25).

This statement ignores the fact that the bonds executed by Seaboard were not limited to those involving cargo claims. Judge Palmieri recognized this when he stated in his opinion that:

"During this same period Seaboard issued bonds on behalf of Eastern in connection with its liability as self-insurer to third parties for bodily injury, property damage, workmen's compensation, and the like." (R 664a).

It is stated in 55 C.J.S. "Marshaling Assets and Security" § 6 that:

"The rule of marshaling does not prevail except where both funds or properties are in the hands of the common debtor of both creditors. . . ."

This rule was invoked in *Port Welcome Cruises, Inc. v. S. S. Bay Belle*, 215 F.Supp. 72, 85 (D. Md. 1963) *aff'd*, 324 F.2d 954 (4th Cir. 1963):

"Since application of the doctrine of marshaling is confined to those instances where assets are those of a common debtor, . . . the argument is inapplicable [citing cases]."

It is clear that the proceeds of the letter of credit are not assets of the trustee. Thus, even were one to consider the setoffs to be a "fund," which we suggest they are not, the marshaling doctrine is inapplicable here.

Moreover, it was held in *Womans Hospital v. Sixty-Seventh Street Realty Co.*, 265 N.Y. 226, 236, 192 N.E. 302 (1934):

"The doctrine of marshalling of assets cannot be applied in the manner asked by the second mortgagee without trenching upon the right of the first mortgagees to compel the application of the rents received in reduction of their mortgages."

In *Duport v. First National Bank of Glens Falls*, 238 N.Y. 261, 268, 43 N.E.2d 34 (1942), it was stated:

"Though, as we have said, the bank, upon equitable principles, was bound to marshal the collateral belonging to the trust estate if the indebtedness due to the bank could be satisfied out of the proceeds of the collateral belonging to the debtor, yet 'the doctrine of equitable marshalling of assets and equitable subrogation is applicable, * * * only where 'it will not trench upon the rights or operate to the prejudice of the party entitled to the double fund' (1 Story's Equity Jurisprudence [10th Ed.], § 633).' (*Womans Hospital v. 67th St. Realty Co.*, 265 N.Y. 226, 235.)"

In *In re Beacon Distributors, Inc.*, 441 F.2d 547, 548 (1st Cir. 1971), the court stated the rule in these terms:

"In such a case, equity will require the first creditor to look first to the property which cannot be reached by the second creditor, but only if it can be done without prejudice to the first creditor or to third parties. *Victor Gruen Associates, Inc. v. Glass*, 338 F.2d 826 (9th Cir. 1964)."

Invoking the marshaling doctrine in this case cannot help but seriously prejudice Seaboard as is made clear in subsection "D" above. While Seaboard is under the onus of the injunction, setoffs to which Seaboard could look for exoneration are melting away where shippers fail to avail themselves of them.

As is stated in 55 C.J.S. "Marshaling Assets and Securities" § 1:

"The doctrine of marshaling is not an absolute rule of law, or an absolute right, or a matter of legal right; marshaling is not founded on contract; nor is it a lien or a vested right or interest. It is founded in principles of natural justice, and is ap-

plied when the ends of justice require its application; it has regard to the rights of all who have interests in the property involved, and applies only when it can be applied equitably and with justice, both to the creditor and to his debtor, as well as to third persons, as discussed *infra* §§ 3-5."

The record on appeal is devoid of evidence that (1) the proceeds of the letter of credit will be sufficient to reimburse Seaboard for its obligations on behalf of Eastern or (2) that the collectible assigned receivables less the setoffs available to the shippers will be insufficient fully to reimburse the banks.

H.

On page 31 of its brief, Manufacturers Hanover urges that Seaboard not be given the benefit of setoffs because:

"Contrary to Seaboard's claim, the law is clear that a set-off under Section 68a is 'permissive rather than mandatory' and is a matter as to which the Bankruptcy Court 'exercises its discretion * * * upon the general principles of equity.'"

What the brief fails to state is that wherever the court in the exercise of its discretion did not apply Section 68a, there were present circumstances tantamount to dishonesty and bad faith. Thus, in *Tucson House Construction Co. v. Fulford*, 378 F.2d 734 (9th Cir. 1967), the court denied a setoff stating at 738:

"But in our view it would be grossly inequitable to permit the set-off where, as here, the claim sought to be used was in effect deliberately 'manufactured' for that purpose."

In the instant case, no gross inequity would result from granting Seaboard the benefit of setoffs. Indeed, to deny Seaboard such benefit would offend the obvious purpose

for the enactment of § 68a, which was to make it unnecessary for a creditor (a shipper) to pay the bankrupt's estate the full value of the freight bill while at the same time being allowed only partial satisfaction of his cargo claim.

Again, in *Stanolind Oil & Gas Co. v. Logan*, 92 F.2d 28, 32 (5th Cir. 1937), *cert. den.*, 302 U.S. 763 (1937), the court of appeals, "applying equitable principles," reversed the district court and allowed a setoff, stating "we disagree with the District Court in his conclusion that defendants were in bad faith." Here, "bad faith" is not even suggested.

A more recent case on this subject is *In re Johnson: Rubenstein v. McLean Bank*, 7 *Collier Bankruptcy Case* 606, where in affirming the allowance of a setoff by the bankruptcy judge, the district court stated at 611:

"As indicated above, the set-off is provable by the bank because it would be provable by the borrower. . . .

"The Receiver further argues that the right of set-off is discretionary and should be denied where equity so dictates. There is no argument with this as a general proposition. Here, however, there is no evidence of conduct of the bank which would warrant denying its claim of set-off as a matter of equity. Nor will the allowance of the set-off result in a windfall to those not entitled to it . . . the bank will not collect twice and indeed will still suffer a substantial loss even after allowance of the set-off."

In the instant case too, the setoff is provable by Seaboard because it would be provable by the shipper. In the instant case too, there is no evidence of conduct by Seaboard which would warrant denying its claim of setoff as a matter of equity. In the instant case too the allowance of the setoff will not result in a windfall. In the instant case, too, Seaboard "will still suffer a substantial

loss even after the allowance of the set-off," indeed after allowance of both setoffs and the proceeds of the letter of credit. (See Wehrell affidavit, R 358a, paragraph 12).

It is noted in *Prudential Ins. Co. of America v. Nelson*, 101 F.2d 441, 443 (6th Cir. 1939), *cert. den.*, 308 U.S. 583 (1939):

"The principle upon which the rule [§ 68a] proceeds is that in case of mutual debts, it is only the balance which is the real and just sum owing by or to the bankrupt."*

In *Yale Express*, on facts essentially parallel to those in the instant case, the Court concluded at 362 F.2d 116:

"Thus, had this been an ordinary bankruptcy, it would have been error to deny the applications for setoff."

Clearly, Judge Friendly discerned nothing inequitable to prevent this conclusion. In the instant case we indeed deal with "an ordinary bankruptcy," and here we respectfully suggest it would be "error to deny the applications for setoff."

I.

At page 30 of its brief, Manufacturers Hanover argues that "Seaboard's alleged set-off right with respect to the accounts, if it arose at all, did not arise until Eastern became insolvent. . . . Accordingly, Manufacturers' rights as assignee of the accounts are prior and superior to Seaboard's set-off rights therein." Such argument is without merit and case authority is to the contrary.

* This principle strongly suggests that when Eastern assigned accounts receivable all that was assigned was "the real and just sum owing . . . to" Eastern, i.e., the freight bill less the cargo claim.

Thus, in *Massachusetts Bonding and Insurance Co. v. State of New York*, 259 F.2d 33, 37 (2d Cir. 1958), this Court stated:

"But if the payment is still in the hands of the principal, its trustee in bankruptcy, or a stakeholder, the surety's rights are superior even to those of formal assignees of the proceeds of the contract, for its rights arise at the time of the making of the surety contract. *Henningsen v. U. S. Fidelity & Guaranty Co.*, supra, 208 U.S. 404, 28 S.Ct. 389, 52 L.Ed. 547; *Prairie State Nat. Bank of Chicago v. United States*, supra, 164 U.S. 227, 17 S.Ct. 142, 41 L.Ed. 412; *In re Scofield Co.*, 2 Cir., 215 F. 45; *In re P. McGarry & Son*, 7 Cir., 240 F. 400."

In *Prairie State* (supra), 164 U.S. at 232, the Court posed the issue between the parties as follows:

"In other words, the rights of the parties depend upon whether ~~Hitchcock's~~ (the surety's) subrogation must be considered as arising from and relating back to the date of the original contract, or as taking its origin solely from the date of the advance by him." (parenthesis supplied)

The Court then concluded at 164 U.S. 240:

"Depending, therefore, solely upon rights claimed to have been derived in February, 1890, by express contract with Sundberg & Company, it necessarily results that the equity, if any, acquired by the Prairie Bank in the ten per cent fund then in existence and thereafter to arise was subordinate to the equity which had, in May, 1888, arisen in favor of the surety Hitchcock. It follows that the Court of Claims did not err in holding that Hitchcock was entitled to the fund, and its judgment is therefore affirmed."

...ing on the rationale of the *Prairie State* opinion, ...rt in *Henningsen v. U. S. Fidelity & Guaranty Co.*,

208 U.S. 404 (1908), reached a similar conclusion stating at 208 U.S. 411-412:

"It seems unnecessary to again review the authorities. It is sufficient to say that we agree with the views of the Circuit Court of Appeals, expressed in its opinion, in the present case:

'Whatever equity, if any, the bank had to the fund in question, arose solely by reason of the loans it made to Henningsen. Henningsen's surety was, upon elementary principles, entitled to assert the equitable doctrine of subrogation; but it is equally clear that the bank was not, for it was a mere volunteer, and under no legal obligation to loan its money.'" (citing the case of *Prairie State* among others).

Accordingly, Seaboard's surety rights to subrogation are prior and superior to the banks' rights as assignees of accounts receivable.

POINT II

The briefs submitted by appellees fail to meet Seaboard's contention that the bankruptcy court lacks summary jurisdiction to determine the proper use and allocation of the proceeds of the letter of credit.

The five briefs filed here by appellees fail to disturb Seaboard's jurisdictional contentions. Seaboard is before this Court as an adverse claimant with possession of the proceeds under an uncontestably substantial and good faith claim, and under the settled authority of *Jaquith v. Rowley*, 188 U.S. 620 (1903) and *In re Horgan*, 158 F. 774 (1st Cir. 1907), it was error for the courts below to order Seaboard to submit to a summary proceeding in bankruptcy where the proper use and allocation of the proceeds is to be determined.

The briefs by appellees not only fail to defend the district court's affirmance of the jurisdictional assertion by the bankruptcy court, but also assume mutually inconsistent—and misleading—positions on the nature of the jurisdictional issue before this Court. This is nowhere more convincingly demonstrated than in the direct contradiction between the approaches adopted by the Eastern trustee, on the one hand, and by Chase and Manufacturers Hanover, on the other.

The Eastern trustee has disclaimed any interest in the resolution of the allocation issue, stating that

“The Trustee makes no claim to the proceeds of the letter of credit in Seaboard's possession. Any determination by the Bankruptcy Court will *not* affect these proceeds.

* * *

“The instant Bankruptcy Rule 701 and 765 proceedings are not actions which seek to compel Seaboard to return any part of the proceeds to the Trustee.” (Brief at 20; original emphasis).

This frank disavowal of interest in the issue parallels the trustee's position below, where the district court observed that “the Eastern trustee states that it is not alleging ‘jurisdiction over the proceeds of the letter of credit and [asking the court to] cause their use or disposition.’” (R 674a n.1).

In contrast, Chase and Manufacturers Hanover argue strenuously that jurisdiction exists over the allocation issue, Chase going so far as to include in its statement of “issues presented for review” (Brief at 2) the question of the bankruptcy court's jurisdiction to order a refund to Chase of excess proceeds of the letter of credit. This formulation of the issues, together with the argument furnished by Chase (Brief at 18-19) in relation to the refund issue, plainly betrays the real alignment of the parties as to the allocation issue. Only the banks exhibit

a genuine interest in the allocation issue, because resolution of that issue will have monetary impact as between Seaboard and Chase (and indirectly Manufacturers Hanover which claims a 25% participation in the letter of credit (R 310a, paragraph 26)), and not at all between Seaboard and the trustee.

The divergent stances taken by the Eastern trustee and by Chase and Manufacturers Hanover demonstrate that the allocation issue is nothing more than a third-party dispute to which the real parties in interest are Seaboard and the banks. Since the Eastern trustee has no direct concern with the allocation of the proceeds, he must, like the trustee in *First State Bank and Trust Company of Guthrie, Oklahoma v. Sand Springs State Bank*, 528 F.2d 350 (10th Cir. 1976), await a plenary trial of the issue.

- A. Because the setoff issue and the issue of the proper use and allocation of the proceeds of the letter of credit do not arise out of the same transaction, summary jurisdiction to determine the setoff issue does not warrant the bankruptcy court's assertion of summary jurisdiction to determine the allocation issue.**

Appellees have failed to offer a satisfactory answer to Seaboard's criticism of the results below, particularly to Seaboard's argument (Principal Brief at 37-38) that summary jurisdiction in bankruptcy over a given issue can extend only to other issues arising from the same transaction. The bankruptcy court asserted jurisdiction to decide the allocation issue on the stated ground that, due to an alleged "intertwining" of issues, Seaboard had consented to such jurisdiction by proceeding as to setoffs (R 538a). The district court rejected the consent rationale, and, refusing to find an "independent basis" for jurisdiction, held that summary resolution of the allocation issue was a "necessary prerequisite" to a final determination of the setoff issue. (R 673a).

The "same transaction" limitation on summary jurisdiction is implicit in the case extensively relied upon by both

Chase (Brief at 12-14) and Manufacturers Hanover (Brief at 35-38), namely, *James Talcott, Inc. v. Glavin*, 104 F.2d 851 (3d Cir. 1939), *cert. den.*, 308 U.S. 598 (1939). There, the court's generalized language that a "close connection" suffices to extend summary jurisdiction, language so eagerly seized upon by the appellees, must be restored to the factual context of that case. It then becomes apparent that the reason why jurisdiction over appellant Talcott's petition extended to the trustee's counterclaim was that both issues arose from identical assignments, i.e., from the same transaction. It is instructive that appellees here, who urge this Court to look to the reasons underlying the *Yale Express* case, should have chosen to ignore the reasons for the result in *Talcott*.

Obviously unable to satisfy the "same transaction" test, Manufacturers Hanover and Chase have proposed their newly formulated "close connection" test for summary jurisdiction. International Harvester, on the other hand, accepts the same transaction test, but then adopts the implausible line that here setoff-related issues and the allocation issue do in fact arise from the same transaction, which International Harvester seemingly identifies as Seaboard's issuance of bonds. To the contrary, the allocation issue arises from, and will be decided with reference to, a related set of agreements in 1974 among Eastern, Associated, and Seaboard, as well as Chase, whereby Seaboard bonded various liabilities of Eastern and Associated and was furnished the Chase letter of credit as collateral. Seaboard's issuance of bonds in 1974 did not give rise to set-offs. Rather, the setoffs (although relating back to 1974 for priority purposes) actually arose only after the insolvencies in 1976, when shippers who owed freight charges to Eastern pressed claims against Seaboard under its bonds.

International Harvester (Brief at 16-19) makes much out of *Katchen v. Landy*, 382 U.S. 323 (1966), as allegedly validating expansive summary jurisdiction in the bankruptcy court for all purposes. An analysis of the rationale

in *Katchen* shows that its holding rests on the sections of the Bankruptcy Act dealing with preferences, notably Bankruptcy Act § 57g, 11 U.S.C.A. § 93(g).^{*} In *Katchen*, the Supreme Court affirmed summary jurisdiction in the bankruptcy court to order return of a voidable preference asserted and proved by a trustee in response to a claim filed by the creditor who received the preference. Jurisdiction was grounded on Section 57g of the Bankruptcy Act, under which the creditor's claim could not be allowed until the amount of the preference had been decided. Here, in contrast to *Katchen*, no preferences are involved, and here the setoff issue has already been decided (albeit, we submit, wrongly) while the allocation issue has been set down for a future hearing. The two issues here are in no sense reverse sides of the same coin, as were the claim and preference issue in *Katchen*, and resolution of the one does not automatically imply resolution of the other.

The Eastern trustee, who does not discuss the same transaction test in terms, advances a related argument (Brief at 19-20) in alleging that Seaboard's jurisdictional objections would result in a "bifurcation" of the issues in this action. To the contrary, any bifurcation of issues results from the inherent limitations of summary jurisdiction in bankruptcy. The reason for different jurisdictional treatment of the setoff issue and the allocation issue is that the two issues spring from different kinds of property in the possession of different parties under different claims of right. As to setoffs, the bankruptcy court

^{*} It is instructive to note that the Tenth Circuit, in its decision in *Katchen*, expressly confined the extension of summary jurisdiction by consent to the trustee's counterclaims for return of voidable preferences. An additional counterclaim not concerning a preference was before that court, but summary jurisdiction over it was denied, on the express ground that it did not arise out of the same transaction on which the creditor's claim was based. *Katchen v. Landy*, 336 F.2d 535 (10th Cir. 1964). On review by the Supreme Court, only jurisdiction as to counterclaims involving preferences was considered or decided, as that Court noted. *Katchen v. Landy*, 382 U.S. at 326 n.1.

has power to act given its constructive possession of the accounts receivable; as to allocation of proceeds, the bankruptcy court lacks power to act due to Seaboard's possession of the proceeds under a substantial good faith claim. To apply the same transaction test here is merely to recognize the jurisdictional implications of, but not in any sense to create, the separate and distinct nature of the issues in this case.

Appellees' arguments, it must be concluded, make no inroads upon Seaboard's positions (a) that the same transaction test applies to set a limit on the extension of summary jurisdiction in bankruptcy, (b) that here setoffs and allocation of proceeds do not relate to the same transaction, and (c) that therefore the allocation issue must be determined in plenary proceedings.

B. The need to resolve the allocation issue in the course of complete administration of the Eastern estate does not justify resolving that issue in summary proceedings in bankruptcy.

Seaboard may not be deprived of its right to plenary adjudication of the legal availability of the proceeds upon the ground, urged by appellees Manufacturers Hanover (Brief at 38-40) and Chase (Brief at 15-17), that the exigencies of complete administration of the Eastern estate justify overriding any statutory limits on summary jurisdiction in bankruptcy. Although appellees continue to insist upon this efficiency rationale, none has refuted Seaboard's observation in its principal brief that if efficiency in administering an estate were uncritically accepted as a ground for summary jurisdiction, then no adverse claimant would ever have a right to a plenary trial.

Again, appellees have simply failed to explain why, in *Jaquith v. Rowley*, 188 U.S. 620 (1903), as in *In re Horgan*, 158 F. 774 (1st Cir. 1907), the surety's right to plenary trial of its right to hold security was upheld,

despite the fact that in each of those cases adjudication of the adverse claim was a "necessary prerequisite" to complete administration of the bankrupt estate. Indeed the Eastern trustee, the Associated trustee, and International Harvester have not even made reference to the *Jaquith* and *Horgan* cases in their respective briefs. Chase (Brief at 14-15) attempts to distinguish the two cases from the instant facts by arguing that in *Jaquith* "the surety's claim to the money it held was not directly related to an issue over which summary jurisdiction existed." This claimed distinction ignores the fact that in both *Jaquith* and *Horgan* the issue of the surety's right to hold security was indeed related to, and was required to be resolved in the course of, complete administration of the bankrupt estate.

Chase and Manufacturers Hanover appeal to the broad jurisdictional concession found in *O'Dell v. United States*, 326 F.2d 451 (10th Cir. 1964), where the court ostensibly upheld jurisdiction in the bankruptcy court to decide all disputes necessary to full administration of a bankrupt estate. Neither appellee, however, took notice of the subsequent limitation imposed on the *O'Dell* doctrine by the Tenth Circuit itself in *First State Bank and Trust Company of Guthrie, Oklahoma v. Sand Springs State Bank*, 528 F.2d 350 (10th Cir. 1976).

Appellees' attempts to explain away the impact upon the *O'Dell* doctrine of this Court's decision in *Law Research Service, Inc. v. Crook*, 524 F.2d 301 (2d Cir. 1975), are unpersuasive. In *Law Research*, this Court carefully analyzed the specialized jurisdictional needs in arrangement and reorganization cases*, where expanded summary

* It is significant that *In re International Power Securities Corp.*, 170 F.2d 399 (3d Cir. 1948), *In re Burton Coal Co.*, 126 F.2d 447 (7th Cir. 1942), and *In re Equity Funding Corp.*, 396 F.Supp. 1266 (C.D. Cal. 1975), *aff'd.*, 519 F.2d 1274 (9th Cir. 1975), are all reorganization cases. Citation of these cases by Manufacturers Hanover (Brief at 39) serves only to reinforce Seaboard's analysis of the limits of the *O'Dell* doctrine.

jurisdiction can be justified in "unusual circumstances." 524 F.2d at 314. Language from *Law Research* cannot properly be taken from its Chapters X and XI context and adapted to this straight bankruptcy, since the reason for the *Law Research* rule (speedy and centralized resolution of disputes needed to uphold the rehabilitative purposes of Chapters X and XI) does not apply here.

Significantly, the Eastern trustee does not advance the argument hazarded by Chase (Brief at 15) that resolution of the allocation issue will have a financial effect upon administration of the Eastern estate.* Seaboard has shown in its principal brief at 19-21 that the total of claims filed jointly by Seaboard and Chase against the Eastern estate will be in the same amount regardless of how Seaboard has applied the proceeds of the letter of credit. The Eastern trustee's evident concession that Seaboard is correct in this evaluation constitutes another reason why this Court should refuse to rest summary jurisdiction over the allocation issue upon alleged efficiencies in administering the estate.

One of Seaboard's arguments in its appeal brief (at 39-40) was that the important non-bankruptcy issues implicit in the allocation dispute are more appropriately determinable in plenary proceedings in the state courts rather than in a summary action in bankruptcy. Chase (Brief at 15-16) has responded with the reductionistic view that the allocation issue is "simple to resolve," involving only a few easily-applied rules governing payment out of proceeds under letters of credit by issuing banks.

Chase conveniently overlooks that, as the issuing bank, it has already paid out the proceeds. Thus, the rules

* International Harvester's argument to similar effect (Brief at 24-26) rests entirely upon the farfetched hypothesis that Seaboard failed to file a claim against the Associated estate until after the bar date. Not only is this hypothesis completely without support in the record (having never been mentioned before the bankruptcy court), but it is also entirely lacking in substance.

requiring banks to pay against conforming documents only—rules which were developed to confine banks to their financing role and to facilitate the use of letters of credit as financing instruments—have no application to the issue in this case of the proper use and allocation of the proceeds. Once proceeds, as here, have been paid out by the bank, the financing purpose of the letter of credit has been attained; the subsequent *use* of the proceeds by the beneficiary is then governed by the underlying agreements between the principals, which alone define the purpose for which the security was given and control its application by the beneficiary, in this case Seaboard. Resolution of the allocation issue* here, therefore, will entail precisely the predominant questions of state law which, as the Supreme Court ruled in *Thompson v. Magnolia Co.*, 309 U.S. 478, 483 (1940), make it “desirable to have the litigation proceed in the state courts.”

The Eastern trustee (Brief 22-23) offers a different version of the efficiency or economy-in-litigation argument, this time alluding to the power of a court, having jurisdiction to enjoin conduct, to retain jurisdiction and modify the injunction in the light of changed circumstances. One

* As to the merits, appellees, as though repetition and wishful thinking might make it so, repeatedly refer to “facts” which are not facts at all concerning the origin and purpose of the letter of credit. International Harvester, for example, includes in its recital of “facts” (Brief at 3) that the letter of credit was issued to Seaboard “on behalf of Eastern alone,” and states again (Brief at 7) that the letter of credit was “furnished by Eastern” as collateral. Chase (Brief at 2, 6) offers similar “factual” averments allegedly bearing upon the scope of the letter of credit, as does Manufacturers Hanover (Brief at 5, 28). Actually the only evidentiary material in the record on the origin and purpose of the letter of credit is the affidavit of Walter S. Wehrell (R353a-358a), wherein Seaboard’s position is set forth, since the affidavit by Howard G. Fuhr, Vice President of Chase (R485a-488a), carefully avoids any statement concerning the origin and purpose of the letter of credit or the nature of the underlying agreements among Eastern, Associated, and Seaboard which control the use of the proceeds by Seaboard.

difficulty with the trustee's argument is that in none of the cited cases is the modification doctrine used as a lever for acquiring jurisdiction where it was formerly lacking. Reference to a doctrine which presupposes jurisdiction over a given issue cannot help the trustee establish such jurisdiction in the first instance. In essence, the trustee's argument begs the question of whether summary jurisdiction ever existed in the bankruptcy court to decide the allocation issue. We submit that such jurisdiction is lacking here.

C. The affirmed jurisdictional decision of the bankruptcy court cannot be sustained on the basis of actual or implied consent.

1. No actual consent was given by Seaboard.

Chase, International Harvester and Manufacturers Hanover introduce into their respective statements of fact assertions to the effect that Seaboard actually consented to summary adjudication of the allocation issue. (Chase Brief at 7; International Harvester Brief at 6; Manufacturers Hanover Brief at 7). These assertions are not statements of fact, but rather arguments, and unconvincing arguments at that, for the following reasons.

In the first place, the few quoted excerpts by which appellees seek to show actual consent have been improperly uprooted from their context of some 200 pages of pre-complaint transcripts. Those hearings were occasioned by an application for an injunction and to punish for contempt, and focused on Seaboard's right to communicate with shippers and to take setoffs. References to the letter of credit were fragmentary and inconclusive, and references to the allocation of the proceeds of the letter of credit were practically non-existent.

Of course, Seaboard did acknowledge from the beginning the bankruptcy court's summary jurisdiction over issues connected with setoffs and accounts receivable. (R

123a-124a, 128a-132a, 158a-160a, 250a-251a). Therefore, what is distinctly unfair about appellees' argument is their tactic of wrenching out of context the several expressions of consent by Seaboard's counsel to jurisdiction over the setoff issue as though it were also consent to adjudication of the allocation issue. By concatenating their selected quotations, appellees evidently hope to impart to them a false continuity and an artificial focus on the allocation issue.

One example of this tactic is found in Manufacturers Hanover's brief (at 44), where an excerpt from one of Mr. Cheser's October 21, 1976, statements is set out as a purported consent to jurisdiction over the allocation issue:

"The Court: Will there be a consent to this jurisdiction by all parties?

"Mr. Cheser: That was expressed last week."
(R 159a).

In fact, what had been expressed at the hearing of October 14, 1976, was consent to resolution of the *setoff* dispute at a single action brought by both trustees under a joint submission of facts. Mr. Cheser had made no reference to the letter of credit, much less to the allocation issue, at the October 14, 1976, hearing.

It is accurate to say that the very first reference in the transcripts to the allocation issue did not occur until the hearing held on October 21, 1976, where Mr. Cheser expressly reserved consent to jurisdiction. In that passage, after discussing the probable extent of Seaboard's exposure on the bonds it had issued, Mr. Cheser stated:

"Regarding the letter of credit there are issues which may or may not come in the lawsuit that is being started. *Until we see the final complaint, we cannot know.* There are issues as to whether the letter of credit was to cover only the obligations of [Eastern] or of [Eastern] and Associated together."
(R 163a; emphasis added).

It is obvious that the express refusal by Seaboard's counsel to consent to jurisdiction over the allocation of the proceeds before seeing the actual complaint carried over to the subsequent hearing of October 26, 1976 (R 204a-251a), which took place before the complaint was served or filed.

It is clear even from the transcript passages reprinted in the Manufacturers Hanover Brief at 42-46 that all parties expected a complaint filed jointly by both trustees and a common stipulation of facts by all parties. Neither of these events materialized. Under these circumstances, Seaboard's counsel could never be said to have consented, or to have been authorized by his client to consent, blindly and in advance to jurisdiction over any claim the Eastern trustee, acting alone, might include in the final complaint.

It was only after service of the complaint that Seaboard, apprised of the precise issues to be contested in this action, was in a position to evaluate the jurisdictional implications of the claims asserted in the third cause of action in the complaint. In response, Seaboard complied exactly with the requirements of Rule 915 of the Rules of Bankruptcy Procedure by objecting to summary jurisdiction over the allocation of proceeds in its first motions responsive to the complaint (R 345a-348a, 371a-372a). In view of Bankruptcy Rule 915, which permits effective objection to jurisdiction up to and including a party's first response to the complaint, this Court should reject appellees' argument that scattered statements at pre-complaint hearings added up to an intentional waiver of Seaboard's right to a plenary trial of the allocation issue.

Moreover, the question of Seaboard's alleged "consent" was extensively argued before the bankruptcy court, where all of the oral statements by which consent was allegedly given had been uttered. That court refused in its discretion to make a finding of fact that consent had been expressed, and chose instead to rest its decision on its theory of implied consent. The district court similarly

refused to find actual consent (R 671a), and we submit that under the circumstances such a conclusion is the only fair one.

2. Seaboard did not consent by implication to summary jurisdiction.

Appellees argue that Seaboard consented by implication to summary jurisdiction in bankruptcy, although Chase (Brief at 17) and Manufacturers Hanover (Brief at 41 n.) acknowledge that the district court rejected the bankruptcy court's reasoning that Seaboard impliedly consented to jurisdiction over the allocation issue by litigating as to setoffs. Still, Manufacturers Hanover (Brief at 46-48) and International Harvester (Brief at 19-20) contend that an implied consent arises from Seaboard's filing of a proof of claim* in the bankruptcy court with respect to the Eastern estate.

However, as was held in *In re Kirchoff Frozen Foods, Inc.*, 496 F.2d 84 (9th Cir. 1974), when an adverse claimant who otherwise objects to jurisdiction files a proof of claim, not as an affirmative request for relief, but under constraint that the period for filing claims might elapse before the claimant's right to retain funds can be determined in plenary proceedings, then filing the proof of claim does not constitute consent to jurisdiction over the adverse claim. *Kirchoff* was decided in reliance upon a case from this Circuit, *In re Eakin*, 154 F.2d 717 (1946). Seaboard's proof of claim in the Eastern estate was sworn to on December 8, 1976, after Seaboard had ob-

* The proof of claim is not part of the Record on Appeal, nor was this argument raised by any party before the bankruptcy court. The frequent resort by Manufacturers Hanover and International Harvester to materials not in the record is ironic in the light of the unjustified criticism concerning the composition of the record levied by those appellees at Seaboard.

jected to summary jurisdiction in its motions* under Bankruptcy Rule 915. Thus, the contested paragraph of Seaboard's proof of claim, like the claim filed by the adverse claimants in *Kirchoff*, was essentially a back-up position seeking relief from the bankruptcy court only "in the event the trustee first prevailed in the dispute initiated by him." 496 F.2d at 86.

The arguments of Manufacturers Hanover and International Harvester relating to Seaboard's proof of claim fail for an additional reason. Both appellees urge that, pursuant to Bankruptcy Rule 306(d), the bankruptcy court has jurisdiction to value Seaboard's security. As Manufacturers Hanover recognizes, Rule 306(d) restates section 57h of the Bankruptcy Act, 11 U.S.C.A. § 93(h). Section 57h, in turn, states that the "value of securities held by secured creditors shall be determined by converting the same into money. . . ." Obviously, neither Bankruptcy Act § 57h nor Bankruptcy Rule 306(d) applies here, where the proceeds of the letter of credit were taken down in cash, so that no valuation is required, and where no party disputes the applicability of the entire \$2,000,000 fund to bonds written by Seaboard for Eastern.

Finally, Manufacturers Hanover makes the rather startling argument (Brief at 48-49) that Seaboard's having sought below to estop the Eastern trustee from litigating the allocation issue was, by implication, a request for "affirmative relief" and thus consent to summary adjudication of the allocation issue itself. Plainly, Seaboard's contention (that, because of the agreements entered into by Eastern, the Eastern trustee cannot equitably advance the argument that the proceeds were allocable to Eastern bonds alone; see Seaboard's principal brief at 21n.) was

* Seaboard's motions to dismiss the complaint and cross-claims were made on December 3, 1976, and December 7, 1976, respectively. The earlier of the two notices of motion, through a typographical error at R346a, is dated "December 31, 1976"; the original of the notice reads "December 3d, 1976."

a defensive position. Far from being a request for affirmative relief, Seaboard's estoppel argument sought to establish the absence of jurisdiction in the bankruptcy court to ever decide the allocation issue on the merits. If Seaboard had succeeded in its estoppel argument, the bankruptcy court would never have had to deal with the merits of the allocation issue at all, but would have drawn the correct conclusion that that issue involves a third-party dispute which the bankruptcy court simply lacks the power to decide.

Dated: New York, New York
March 21, 1978

Respectfully submitted,

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United States Court of Appeals

FOR THE SECOND CIRCUIT

IN RE EASTERN FREIGHT WAYS, INC.,

SIDNEY B. GLUCK, Trustee in Bankruptcy of EASTERN FREIGHT
WAYS, INC.,

Bankrupt,

Plaintiff-Appellee,

against

SEABOARD SURETY COMPANY,

Defendant-Appellant,

MANUFACTURERS HANOVER TRUST COMPANY, individually and
as agent for other institutional lenders, INTERNATIONAL HARVES-
TER CREDIT CORPORATION, FRUEHAUF CORPORATION
and THE CHASE MANHATTAN BANK, NATIONAL ASSOCIA-
TION, and THOMAS J. CAHILL, Trustee in Bankruptcy of ASSO-
CIATED TRANSPORT, INC.,

Defendants-Appellees.

**AFFIDAVIT
OF SERVICE**

STATE OF NEW YORK,

COUNTY OF NEW YORK, ss:

Bernard S. Greenberg

being duly sworn,

deposes and says that he is over the age of 21 years and resides at
162 East Seventh Street, New York, N.Y.

That on the 21st day of March, 1938

he served the annexed **Reply Brief of Defendant-Appellant**
Seaboard Surety Company

upon

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in this action, by delivering to and leaving with said attorneys

two

true copies to each thereof.

DEPONENT FURTHER SAYS, that he knew the persons so served as aforesaid to be the persons mentioned and described in the said action.

Deponent is not a party to the action.

Sworn to before me, this 21st

day of March, 1978

Dwight L. Allstey

Robert W. Johnson

ROB
Notary P

SON
New York

Qualified
Commission

County
of New York, 1978